

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Release copies to District

Date

Surname

Date: MAR 27 2000

Contact Person:

ID Number:

Telephone Number:

Employer Identification Number:

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were incorporated under the nonprofit laws of the State of [redacted] on [redacted]. Your proposed articles of incorporation state that you were organized to promote international education and goodwill through English as a second language by providing scholarships for financially challenged adults who wish to study English as a second language. Your funds will provide for scholarships for needy students to attend [redacted]. In your corporate charter you state that funds will also be used to expand the [redacted] facility. You have proposed to amend your articles to exclude this provision. In addition, your articles provide that you are organized and operated exclusively for educational purposes within the meaning of section 501(c)(3) of the Code.

[redacted] is a sole proprietorship, for-profit organization. Your incorporators are listed as [redacted] and [redacted].

You submitted a signed set of by-laws with Form 1023. These by-laws provide that the president shall be the chief executive officer of the corporation and shall, subject to the control of the Board of Directors, supervise and control the affairs of the corporation and the activities of the officers. He may also carry out other duties as may be required of him or her by law.

Your executive director is [redacted]. [redacted] is also the owner and director of [redacted]. The other members of your board are [redacted] secretary and [redacted] treasurer.

Your activities include only the solicitation of grants and other philanthropic funding, and the administration of those funds. You plan to spend 100% of your time seeking funds. However, upon receipt of funding, you will spend 75% of your time seeking additional funds and 25% of time reviewing student eligibility and administering funds to students. You state that upon receipt of grants or other philanthropic funds, 80% of the funds will be designated for payment of student tuition, 10% will be paid as a commission to the independently contracted grantwriter, and 10% will be allocated to [redacted].

[REDACTED] for administrative costs (office supplies, postage, telephone expenses, secretarial wages, and other expenses incurred during the seeking and distribution of funds).

Section 501(a) of the Code provides, in part, that organizations described in section 501(c) are exempt from federal income tax. Section 501(c)(3) describes, in part, an organization which is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, no part of the net earnings of which inures to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order for an organization to be exempt under section 501(c)(3) of the Code it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholder of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations defines the term "charitable" as including the advancement of education.

Rev. Rul. 66-103, 1966-1 C.B. 135, holds that a nonprofit organization which provides awards and grants, including scholarships and fellowship grants, to needy individuals to enable them to continue their work in the creative arts, as well as to continue their education and studies, with no monetary benefit to the donor organization, is entitled to exemption from federal income tax under section 501(c)(3) of the Code.

Rev. Rul. 69-257, 1969-1 C.B. 151, states that a nonprofit organization awarding scholarships based on scholastic ability without regard to financial need, may qualify for exemption under section 501(c)(3) of the Code.

Rev. Rul. 76-441, 1976-2 C.B. 147, presents two situations concerning school operations. In the first scenario a nonprofit school succeeded to the assets of a for-profit school. While the former owners were employed in the new school, the board of directors was completely different. The ruling concludes that the transfer did not serve private interests. Part of that conclusion was based on the independence of the board. In the second scenario, the for-profit school converted to a nonprofit school. The former owners became the new school's directors. The former owners/new directors benefited financially from the conversion. The ruling concludes that private interests were served. The conclusion is stated as follows:

[REDACTED]

The directors were, in fact, dealing with themselves and will benefit financially from the transaction. Therefore, (the applicant) is not operated exclusively for educational and charitable purposes and does not qualify for exemption from federal income tax under section 501(c)(3) of the Code.

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the Supreme Court stated that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under section 501(c)(3) of the Code, regardless of the number or importance of statutorily exempt purposes.

Operating for the benefit of private parties constitutes a substantial nonexempt purpose. Old Dominion Box Co. v. United States, 477 F. 2d 340 (4th Cir. 1973), cert. Denied 413 U.S. 910 (1973).

Leon A. Beechly v. Commissioner, 35 T.C. 490 (1960), provided that where an exempt organization engages in a transaction with a related interest and there is a purpose to benefit the private interest rather than the organization, exemption may be lost even though the transaction ultimately proves profitable for the exempt organization.

The petitioner in est of Hawaii, 71 T.C. 1067 (1979), conducted training, seminars and lectures in the area of intrapersonal awareness. Such activities were conducted under licensing arrangements with various for-profit corporations. The licensing agreements were conditioned on the petitioner maintaining tax exempt status. The petitioner argued that it had no commercial purpose of its own and that its payments to the for-profits were just ordinary and necessary business expenses. The Court did not agree.

To accede to petitioner's claim that it has no connection with International (the for-profit licensor of the educational program) is to ignore reality. While it may be true that the same individuals do not formally control them, International exerts considerable control over petitioner's activities. It sets the tuition for the standard training and requires a minimum number of such trainings. It requires petitioner to conduct regular seminars and to host special events. It controls the programs conducted by petitioner by providing trainers who are salaried by and responsible to EST, Inc. and it further controls petitioner's operations by providing management personnel who are paid by and responsible to EST, Inc. In short, petitioner's only function is to present to the public for a fee ideas that are owned by International with materials and trainers that are supplied and controlled by EST, Inc. Moreover, we note that petitioner's rights vis-à-vis EST, Inc., International, and PSMA are dependent on the existence of its tax-exempt status—an element that indicates the possibility, if not the likelihood, that the for-profit corporations were trading on such status...

Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc. benefited substantially from the operation of petitioner, (Emphasis added).

In P.L.L. Scholarship v. Commissioner, 82 T.C. (1984), an organization operated bingo at a bar for the avowed purpose of raising money for scholarships. The board included the bar owners, the bar's accountant, also a director of the bar, as well as two players. The board was self-perpetuating. The Court reasoned that since the bar owners controlled the organization and appointed the organization's

directors, the activities of the organization could be used to the advantage of the bar owners. The organization claimed that it was independent because there was separate accounting and no payments were going to the bar. The Court was not persuaded.

A realistic look at the operations of these two entities, however, shows that the activities of the taxpayer and the Pastime Lounge were so interrelated as to be functionally inseparable. Separate accountings of receipts and disbursements do not change that fact.

The Court went on to conclude that the organization had a substantial nonexempt purpose.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court was called on to decide whether benefits to third parties, who were not members, would prevent the organization from being recognized as an exempt organization within the meaning of section 501(c)(3) of the Code. The Court concluded that the organization could not confer substantial benefits on disinterested persons and still serve public purposes within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations.

Secondary benefits which advance a substantial purpose cannot be construed as incidental to the organization's exempt educational purpose. Indeed, such a construction would cloud the focus of the operational test, which probes to ascertain the purpose towards which an organization's activities are directed and not the nature of the activities themselves.

In International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), the Tax Court considered the qualification for exemption under section 501(c)(3) of the Code of a non-profit corporation that conducted continuing medical education tours. The petitioner had three trustees. Mr. Helin, who was a shareholder and the president of H & C Tours, a for-profit travel agency. Mr. Regan, an attorney, and a third director who was ill and did not participate. Mr. Helin served as executive director. The petitioner shared offices with H & C Tours. The petitioner used H & C Tours exclusively for all travel arrangements. The petitioner's contract with H & C Tours permitted it to acquire competitive bids, but provided that H & C Tours would always get the bid if it was within 2.5%. There is no evidence that the petitioner ever sought a competitive bid. The Court found that a substantial purpose of the petitioner was benefiting the for-profit travel agency. It concluded that:

When a for-profit organization benefits substantially from the manner in which the activities of a related organization are carried on, the latter organization is not operated exclusively for exempt purposes within the meaning of section 501(c)(3) even if it furthers other exempt purposes.

We find that a substantial purpose of petitioner's operations was to increase the income of H & C Tours. H & C Tours benefits from the distribution and production of brochures which solicit customers for tours arranged by H & C Tours. Approximately 90 percent of petitioner's total revenue for 1977 was expended on production and distribution of brochures. The terms of the Travel Service and Administrative Support Agreement further insured that H & C Tours would substantially benefit from petitioner's operations. Petitioner did not solicit competitive bids from any travel agency other than H & C Tours.

Providing scholarships in furtherance of educational purposes may be an exempt activity within the meaning of section 501(c)(3) of the Code. See Rev. Ruls. 68-103 and 69-257, supra. However, you must first show that you are organized and operated exclusively for these purposes. To satisfy the operational test your resources must be devoted to programs that qualify as exclusively charitable within the meaning of section 501(c)(3) of the Code.

You were created by the owner of [REDACTED] to award scholarships to low-income students attending [REDACTED]. Devoting your assets to a for-profit entity for use in its educational activities is a substantial nonexempt purpose which cannot be construed as incidental to your exempt educational purpose. See Better Business Bureau v. Commissioner, supra, and American Campaign Academy v. Commissioner, supra.

You also appear to have the substantial purpose of increasing the income of [REDACTED] and [REDACTED] the owner, because you are designed to attract and retain students at the school. In addition, [REDACTED] retains ten percent of the funds that you raise. Like the organization in P.L.L. Scholarship v. Commissioner, supra, your activities are so interrelated with [REDACTED] as to be functionally inseparable.

Furthermore, because [REDACTED] sets the tuition for courses at the academy and requires a minimum number of hours for such courses, he controls the amount of profit that he earns and will benefit financially from transactions between you and [REDACTED]. Also, as a director on your board, [REDACTED] benefits from the manner in which your activities are carried on. Therefore, like the organizations in est of Hawaii v. Commissioner, and International Postgraduate Medical Foundation v. Commissioner, supra, you are not operated exclusively for exempt purposes within the meaning of section 501(c)(3) of the Code because you serve private, rather than public, interests. See also, Rev. Rul. 78-441, Old Dominion Box Col v. United States, and Leon A. Beeghly v. Commissioner, supra.

In summary, you are organized and operated for the substantial nonexempt purpose of benefiting the private interests of [REDACTED] and the [REDACTED]. Conferring impermissible benefits on [REDACTED] who occupies a position of control and influence in your organization, also violates the statutory prohibition against private inurement.

Accordingly, you do not qualify for exemption as an organization described in section 501(c)(3) of the Code and you must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any

[REDACTED]

proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
Sadie Copeland, T:EO:RA:T:4, Room 6236
1111 Constitution Ave, N.W.
Washington, D.C. 20224

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

~~Gerald V. Sack~~

Gerald V. Sack
Manager, Exempt Organizations
Technical Group 4

cc: State officials

[REDACTED] [REDACTED]